

October 19, 2001

Mr. Bill Lyons, Jr.  
Secretary of Agriculture  
California Department of Food and Agriculture  
1220 N Street  
Sacramento, California 95814

Dear Secretary Lyons:

If the Secretary of Agriculture is going to call a hearing on the make allowance for Class 4A milk in response to CDI's petition then we petition the Secretary of Agriculture to expand the hearing to include Class 4B milk as well. Natural gas costs have more than doubled from the base period when the make allowance was last adjusted in California. Electrical costs are up almost 2.5 times since the last make allowance hearing for milk going into cheese (Class 4b products). Land O' Lakes experienced severe power interruptions earlier this year and the cost to Land O' Lakes has been substantial. These interruptions changed schedules, had adverse effects on milk quality because farm tanks could not be washed and in general increased inefficiencies throughout the entire operation, including the plant as well as office staff. The last make allowance hearing was held in 1997 and so other costs have also increased so far as cheese processing is concerned.

Land O' Lakes not only suffered power interruptions, but there were other costs incurred as well. As an example, because of the power interruptions, milk was dumped and not processed. This cost Land O' Lakes \$112,000. The utility bills were also higher. Natural gas increased very dramatically for a time, but it has since declined. Because of the power interruptions, Land O' Lakes invested \$2.9 million for standby electrical power. There were times during the peak electrical rates where it made sense for Land O' Lakes to generate some of its electrical power needs with the use of the standby facility. In any case, a make allowance adjustment based upon the results of the cost audit will not make up for past losses by Land O' Lakes caused by the energy crisis earlier this year.

The Department of Food and Agriculture is completing a cost audit that is based upon invoices for natural gas and electricity for plant operations in California. This cost audit should clearly show the increased costs of manufacturing Class 4a and Class 4b milk products. We are recommending that the Secretary of Agriculture adjust the make allowance for cheese (Class 4b milk) to reflect the increased costs that were caused by the increased energy costs.

The current make allowances for powder, butter and cheese are \$.14, \$.097 and \$.169 respectively. The new make allowance for Class 4b should reflect the increased costs for making cheese as a result of the higher costs of natural gas and electricity since the last make allowance hearing. The 9 plant average cost per pound of cheese for natural gas was .0038 per pound and the 9 plant average cost per pound of cheese for electricity was .0065. These were the costs that were published by the Dairy Marketing Branch, CDFA on May 2001.

At the make allowance hearing on May 31, 2001, the Department had prepared a cost analysis showing the effects of increased energy costs based upon March 2001 invoices. The Department is in the process of analyzing the effects of invoices for August 2001. This analysis will be completed shortly. In any case, as a result of the last cost audit, the panel report showed that the panel recommended an increase in the cheese make allowance of .7 cents per pound. This would have increased the make allowance for cheese from 16.9 cents to 17.6 cents per pound. The Grade AA butter make allowance would have been adjusted from 9.7 cents to 10.1 cents per pound and the non fat dry milk would have been adjusted from 14.0 cents to 16.7 cents per pound. We are recommending that based upon the cost audit for August 2001 that the Secretary adjust the make allowance for cheese, powder and butter. In other words, the Secretary is urged to make a cost justified change in the make allowances for Class 4a and Class 4b products. However, if only energy cost increases would be considered as a basis for changing the make allowance then we urge the Department as a basis use the energy prices that existed when the make allowances were last changed for Class 4a and Class 4b. We also urge that the Department use as a basis the electricity cost per pound of product and the natural gas cost per pound of product that existed when the make allowances were last changed for Class 4a and Class 4b (see second last paragraph of this petition). In this way the increased utility costs could be applied to the base natural gas cost per pound of product and the base electricity cost per pound of product to determine the true increase in costs of processing Class 4a and Class 4b products as a result of energy cost changes.

The electricity costs for Land O' Lakes operation for August 2001 in Tulare was \$.1065 per kilowatt-hour. The rate was \$.042 per kilowatt-hour in 1997. The price of natural gas was \$.648 per therm in August 2001 and it was \$.319 in 1997. The percentage increase for natural gas was 103.13 percent, which would result in an increase of .0039 in the cost of making cheese (103.13 percent times .0038). The percentage increase for electricity from 1997 to August 2001 was 153.57 percent which results in an increase of .0100 in the cost of making cheese (153.57 percent times .0065). The combined increase in the cost of making cheese due to utility cost increases at the Land O' Lakes plant in Tulare amounted to \$.0139

per pound of cheese. Based upon the increases in utility costs in the Land O' Lakes operation would suggest an adjustment in the make allowance for cheese from \$.169 per pound of cheese to \$.1829 per pound of cheese. But, as indicated before, we are recommending that the Secretary use the results of the cost audit for the cheese plants used in the cost survey published by the Department of Food and Agriculture. These results may vary from the Land O' Lakes experience and these results should be, in our opinion, be used to adjust the make allowance for cheese in the Class 4b formula.

Of course, there is also the whey fat side of the equation. Whey fat is part of the pricing formula for Class 4b milk. The current make allowance for Grade B butter in the cheese formula is .097 which is the make allowance for Grade AA butter. The Dairy Marketing Branch of CDFA published butter utility costs in May 2001. This, of course, is being updated and the new published version will include the cost audit based upon utility costs for August 2001. In any case, the cost of natural gas per pound of butter was .0017 and the cost of electricity per pound of butter was .0032. Based upon the Land O' Lakes operation, the cost of natural gas increased by 103.13 percent, which would increase the cost of processing butter by .00175 (1.0313 times .0017). The cost of electricity increased by 153.57 percent, which would increase the cost of processing butter by .0049 (1.5357 times .0032). The combined increases in the cost of converting whey fat to Grade B butter due to utility cost changes at the Land O' Lakes plant in Tulare amounted to \$.0067 per pound. Based upon the increases in utility costs in the Land O' Lakes operation would suggest an adjustment in the make allowances for Grade AA and Grade B butter from \$.097 to \$.104 per pound. But, as indicated before, we are recommending the use of the cost audit for butter plants to evaluate the needed increases in the make allowances due to utility cost changes. These results may be different from the Land O' Lakes operation.

Section 300. Subparagraph (E) will be amended as follows:

- (1) The Cheese hundredweight price shall be the price per hundredweight computed by the sum of the following:
  - (a) The price per hundredweight computed by using the simple average of the 40 pound block price quotations for the last significant transaction for Cheddar cheese at the Chicago Mercantile Exchange, less a marketing adjustment of one and two-tenths (\$.012), less a Cheddar cheese manufacturing cost allowance of **eighteen and twenty nine hundredths (\$.1829)**, all multiplied by a yield factor of ten (10).
  - (b) The price per hundredweight computed by the formula using the simple average of the Grade AA butter price quotations for

the last significant trading action for the sale, offer or bid of butter at the Chicago Mercantile Exchange, less a manufacturing cost allowance of **10 and four tenths cents (\$0.104)**, all multiplied by a yield factor of twenty-seven-hundredths (0.27).

The remainder of the language remains the same. The energy situation is certainly a very serious situation for dairy manufacturing operations in California. We urge the Secretary to call a hearing on this issue as soon as possible. Please be advised that the specific numbers for the make allowance are subject to change based upon the results of the cost audit. Land O' Lakes will testify to a "cost justified" change in the make allowance. Those make allowances listed in the above paragraphs in words and numbers are subject to change.

About 70 percent of the milk is manufactured into butter, powder and cheese. There is no where else to go. The producers need these manufacturing facilities. The alternative is to dump milk or to move milk out-of-state for further processing. This situation occurred in the early 1980's and cost producers thousands of dollars. An adjustment in the make allowances for Class 4a and Class 4b products is not going to have an adverse effect on consumers. It is absolutely imperative that we maintain a healthy environment for dairy manufacturing firms so these firms can continue to expand to accommodate the continued growth in milk production in California.

My final point is that it is very important to use the correct base if only utility cost percentage growth is going to be considered to adjust the make allowances for butter, powder and cheese (and this appears to be what the panel recommended the last time a hearing was held on this issue). Frankly, if that same procedure is going to be used for another hearing, the correct base for natural gas cost per pound of cheese and the electrical cost per pound of cheese is that which existed when the make allowance was last adjusted for cheese. The same argument holds true for butter and powder. And finally, the base for the average cost per therm for natural gas and the average cost per kilowatt hour for electricity should represent those rates that existed when the make allowances were last adjusted for Class 4a and Class 4b products. In this way the August 2001 rates for natural gas and electricity would be compared to the correct base period and those percentage increases would be applied to the average cost per pound of cheese, butter and powder in the relevant base period when the make allowances were adjusted for Class 4a and Class 4b products. If this is done correctly, then it is possible to accurately reflect the increased costs of making manufactured products because of the increased energy costs. We urge that the Department publish the base rates for electricity and natural gas for butter, powder and cheese and that they also publish the base period cost per pound of cheese, per pound of butter and per pound of powder for electricity and natural gas. And finally, the Department is urged to publish the average electrical rates and the natural gas rates for butter, powder and cheese plants reflecting the invoices for August 2001.

The above information if published prior to the hearing will help participants prepare testimony for the make allowance hearing, if called.

Sincerely,

James W. Gruebele  
Consultant for Land O' Lakes

Cc: David Ikari